Supreme Court, U.S.
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NO. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1994

CAPITOL INDEMNITY CORPORATION

Petitioner,

v.

UNITED STATES OF AMERICA

Respondent.

Petition for a Writ of Certiorari
to the United States Court of
Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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April 21, 1995

QUESTIONS PRESENTED FOR REVIEW

Is a surety's right of equitable subrogation under Pearlman vs. Reliance Insurance Company, 371 U.S. 132, 136-137 (1962) a "security interest" subject to filing requirements under Article 9 of the Uniform Commercial Code and 26 U.S.C. §6323(c)?

PARTIES TO PROCEEDINGS

The parties to Case No. 93-3633 in the United States Court of Appeals for the Seventh Circuit were Capitol Indemnity Corporation, Mount Vernon (Illinois) Township High School District 201 and the United States of America. The parties before this court are the same as the parties below.

Capitol Indemnity Corporation is a wholly owned subsidiary of Capitol Transamerica Corporation. Capitol Transamerica Corporation is publicly traded and has no other subsidiaries, parent companies, affiliates, or shareholders which are required to be listed pursuant to Rule 29.1.

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CAPITOL INDEMNITY CORPORATION

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Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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PETITION FOR A WRIT OF CERTIORARI

Capitol Indemnity Corporation respectfully petitions for a writ of certiorari to review the judgment and order of the United States Court of Appeals for the Seventh Circuit entered

on November 30, 1994 and its Order of January 23, 1995, denying a rehearing.

OPINIONS BELOW

The November 30, 1994 order of the Seventh Circuit is reported at 41 F.3d 320 (7th Cir. 1994) and is reprinted in the Appendix ("App") at p. 1a. The Seventh Circuit denied a rehearing on January 23, 1995.

JURISDICTION

The United States Court of Appeals for the Seventh Circuit issued its opinion on November 30, 1994 and denied rehearing on January 23, 1995. This Court has jurisdiction to review the judgment of the United States Court of Appeals pursuant to 28 U.S.C. §1254(1). The Seventh Circuit's decision is in conflict

with Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); In re J. V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); and Home Indemnity Co. v. United States, 433 F.2d 764, 765 (Ct. Claims 1970). The District Court had jurisdiction under 26 U.S.C. §7426 and 28 U.S.C. §1346(e). The Seventh Circuit had jurisdiction pursuant to 28 U.S.C. §1291.

STATUTORY PROVISIONS INVOLVED

26 U.S.C. §6323(c), 810 ILCS §5/9-102(2) and 810 ILCS §5/9-302 are lengthy and are set forth in the appendix.

STATEMENT OF THE CASE

Petitioner is a surety company which bonded a public works project for Mt. Vernon (Illinois) Township High School

District 201. The bonded principal, B & H Construction Company ("Contractor") failed to pay subcontractors and materialmen and to complete the project. The School District then called upon Capitol to pay the subcontractors and complete the project under its bond; Capitol did so.

B & H also failed to pay withholding taxes due on payroll unrelated to the Mt. Vernon project. The United States filed a tax lien on Mt. Vernon School District. Capitol then filed this action to protect its rights in the contract funds. Both the IRS and Capitol filed cross motions for summary judgment. On August 23, 1993, the trial court ruled against the United States and in favor of Capitol. The Seventh Circuit reversed the trial court on various grounds including a

holding that Capitol was required to file a UCC Financing Statement to protect its equitable rights of subrogation and therefore could not prevail against the Internal Revenue Service under 26 U.S.C. §6323(c).

REASONS FOR GRANTING THE WRIT

The Court should grant the petition to clarify the rights of a contract bond surety under 26 U.S.C. §6323(c) and Article 9 of the Uniform Commercial Code in order to promote uniformity and predictability of the rights of various parties to contract funds for construction projects throughout the United States. The Seventh Circuit decision is in direct conflict with Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843, (1st Cir.

1969); In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); and Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970) which was decided in view of the Uniform Commercial Code as adapted in Illinois.

26 U.S.C. §6323(c) gives a surety a "superpriority" over the IRS lien if it could prevail over a judgment lienholder under state law.

As a contract bond surety, Capitol has the right of equitable subrogation:

> "... a surety who pays the debt of another is entitled to all of the rights of the person he has paid to enforce his rights to be reimbursed". Pearlman vs. Reliance Insurance Company, 371 U.S. 132, 136-137 (1962).

Such subrogation rights have long been recognized by the Court.

Pearlman v. Reliance Insurance Company, 371 U.S. 132, 136-137 (1962); Henningsen v. United States Fidelity and Guaranty Co., 208 U.S. 404 (1905); Prairie State National Bank v. United States, 164 U.S. 227 (1956).

Such subrogation rights are extra contractual. The distinction between a surety's rights under (1) subrogation; and (2) a contract (i.e. a General Indemnity Agreement) is critical to any UCC analysis. As two prominent UCC commentators have noted:

> "Article Nine applies only to consensual security interests. The surety's subrogation claim is not consensual, but is based on the **'status *** inhering in a surety.** Accordingly, conflicts between the rights of the surety and third parties must be resolved

> outside Article Nine." White and Summers, Uniform Commercial Code, 3rd ed. at 948.

To Petitioner's knowledge, no American court in thirty years has held that a surety's subrogation[1] rights are subject to UCC filing requirements. The drafters of the Uniform Commercial Code expressly rejected any efforts to require a surety to perfect its subrogation rights to contract funds by filing under Article 9. See **Uniform Laws Annotated, Uniform Commercial Code, Official Draft, Text and Comments**, at 773, 777 (1952);

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[1] The Sixth Circuit ruled against a surety in a case that dealt with a surety's contractual rights under an indemnity agreement as opposed to the extracontractual subrogation rights of a surety. In re Construction Alternatives 2 F.3d 670 (6th Cir. 1993). As noted above, there is a clear distinction between consensual security interests and a surety's subrogation rights.

Uniform Laws Annotated, Uniform Commercial Code, Changes in text and Comments, at 25-26 (1953). quoted in Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); T. Scott Leo, Construction Contract Surety and Some Suretyship Defenses, 34 Wm. & Mary L. Rev. 1225, 1234 n. 31 (1983).

As Judge Robert Brauchner (one of the drafters of Article 9) has explained -- a surety's equitable right is not a security interest and therefore is not subject to the perfection requirements of Article 9. Instead, it is one of those equitable rights which survived the enactment of the UCC because the UCC did not even purport to affect it. Canter v. Schlager, 358 Mass. 789, 267 N.E.2d 492, 494.

The First Circuit cogently outlined the history behind the exemption of a surety from the filing requirements of Article 9:

> "The Surety Companies' representatives convincingly took the position that subsection (7) as it stands is a complete reversal of the case law not only of the Supreme Court of the United States but also of the highest courts of most of the states. They cited Prairie State National Bank v. United States, 164 U.S. 227, 17 S.Ct. 412 (1896) ; United States v. Munsey Trust, 332, U.S. 404, 28 S.Ct. 1599, 91 L.Ed. 2022 (1947) at 240; 9 Am.Jur. 72 §§ 114, 115, 43 Am. Jur. 939, 197 et seq.; 60 C.J. Subrogation § 87; Stearns Law of Suretyship, 5th Ed. (1951), Page 472; Appeal of Lancaster County Natl. Bk., 304

Pa. 437, 155 A. 859 (1931); and 127 A.L.R. 974, 976.

"Under the cited case law, the surety's rights come first as to the funds owing by the owner unless the surety has subordinated its right to the bank. Subsection (7) of the Code as written would reverse the situation and give the bank priority in all cases.

"Under existing case law, both the contractor and the bank are in a position to bargain with the surety which may or may not be willing to subordinate its claim. Under subsection (7) as written in the Code the surety company would have nothing to bargain about." Uniform Laws Annotated, Uniform Commercial Code, Official Draft, Text and Comments , at 773, 777 (1952);

> Uniform Laws Annotated, Uniform Commercial Code , Changes in Text and Comments, at 25-26 (1953). quoted in Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st. Cir. 1969)

The Eighth Circuit and the Court of Claims both concur with the Shawmut National Bank result and reasoning. In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970).

These holdings are in accord with virtually all courts examining the issue. **Alabama** First Ala. Bank., etc. v. Hartford Acc. & I. Co., 430 F.Supp. 907 (N.D. Ala. 1977); **Alaska** Alaska State Bank v. Gen Ins. Co., 579 P.2d 1362 (Alaska 1978); **Florida** McAtee v. United States Fidelity & Guaranty Ins. Co., 401

F.Supp. 11 (N.D.Fla. 1075); Transamerica Ins. Co. v. Barnett Bank, 540 So.2d 113, 117 (Fla. 1989); **Georgia** Argonaut Ins. Co. v. C & S Bank of Tifton, 140 Ga.App. 807, 232 S.E.2d 135 (Ga.App 1976); **Illinois** Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970); **Iowa** First Fed. State Bank v. Town of Malvern, 270 N.W.2d 818 (Iowa 1978); **Kansas** United States F&G Co. v. First State Bank of Salina, 208 Kan. 738, 494 P.2d 1149 (Kan. 1972); **Kentucky** National Sur. Corp. v. State Nat. Bank of Frankfort, 454 S.W.2d 354 (Ky.App. 1970); **Maryland** Finance Co. of America v. U.S. Fid & Guar. Co., 277 Md. 177, 353 A.2d 249 (Md. App. 1976); **Massachusetts** Canter v. Schlager, 267 N.E.2d 492 (Mass. 1971); **Michigan** American Oil Co. v. L.A. Davidson, Inc., 290 N.W.2d 144 (Mich.

App. 1980); **Minnesota** In Re J.V. Gleason Co., 452 F.2d 1219 (8th cir. 1971); **Missouri** First State Bank v. Reorganized Sch. Dist. R-3, Bunker, 495 S.W.2d 471 (Mo.App. 1973); **Oklahoma** Mid-Continent Cas. Co. v. First National Bank & Trust Co., 531 P.2d 1370 (Okla. 1075); **Pennsylvania** Jacobs v. Northeastern Corp., 416 Pa. 417, 206 A.2d 49 (Pa.App. 1965); **Texas** Interfirst Bank Dallas v. United Fidelity and Guaranty Company, 774 S.W.2d 391, 398 (Tex.App. 1989); **Vermont** First Vermont Bank & Trust Co. v. Village of Poultney, 349 A.2d 722 (Ver. 1985); and **Wisconsin** Matter of Don's Elec. Inc., 65 B.R. 399 (Bkrtcy. W.D. Wis. 1986).

Accordingly, the Petitioner submits that it is not required to file a UCC Financing Statement in order to protect

its rights under 26 U.S.C. §6323(c) because the UCC Article 9 does not govern its extra contractual rights.

Notwithstanding such well established case law, however, the Seventh Circuit failed to recognize such a distinction in its analysis:

> "... the surety's claim was not perfected, thus not protected under local law against a judgment lien," See 810 ILCS 5/9-302 (Illinois law requires sureties to file financing statement in appropriate office in order to perfect claim." Opinion at 12.

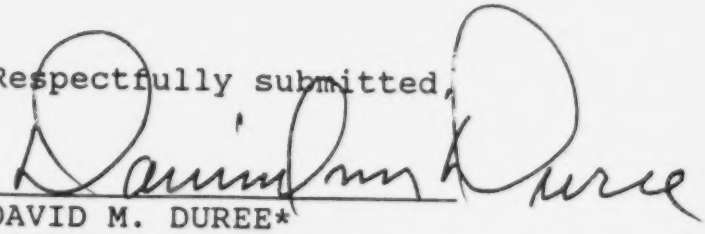
The court has not cited any case nor has Petitioner has found any American case in the last thirty years that has construed Article 9 of the UCC to preempt a surety's rights of equitable right of subrogation under the Pearlman doctrine. Such opinion conflicts with the First Circuit opinion in Shawmut National Bank

v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); the Eighth Circuit opinion in In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); and the Court of Claims decision in Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970). It has also taken the "uniformity" out of Article 9 of the Uniform Commercial Code as to a surety's right of equitable subrogation.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,



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In the

United States Court of Appeals

For the Seventh Circuit

No. 93-3633

CAPITOL INDEMNITY CORPORATION,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Third Party Plaintiff-Appellant,

v.

MT. VERNON TOWNSHIP HIGH SCHOOL DISTRICT 201,

Third Party Defendant-Appellee.

Appeal from the United States District Court
for the Southern District of Illinois, Benton Division.
No. 92 C 4141—J. Phil Gilbert, *Chief Judge.*

ARGUED SEPTEMBER 20, 1994—DECIDED NOVEMBER 30, 1994

Before CUMMINGS, FERGUSON,* and COFFEY, *Circuit Judges.*

CUMMINGS, *Circuit Judge.* This appeal involves competing rights in a "progress payment" earned during the course of an ill-fated construction contract. The payment was designated for the general contractor, levied on by

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* The Honorable Warren J. Ferguson, United States Circuit Judge for the Ninth Circuit, is sitting by designation.

the Internal Revenue Service, and claimed by the completing surety for itself and a host of subcontractors. On cross-motions for summary judgment, the district court found that the funds belonged in part to the subcontractors and in part to the surety. The government has appealed this determination and we reverse.

FACTS

In May 1991, Mt. Vernon Township High School District No. 201 (the "District") contracted (in the "Contract") with B & H Construction Company ("B & H") for asbestos removal and other work. B & H was to complete the project by August 9, 1991, in time for the new school year. The District agreed to a contract price of $248,340, due in monthly progress payments upon certification by the project architect that B & H had completed its work satisfactorily and paid its subcontractors and suppliers. The monthly payments would represent the work performed to date, less 10% "retainage" to be withheld until completion of the project and extinction of all liabilities to subcontractors, suppliers or other creditors. B & H agreed to obtain performance bonds and payment bonds for the protection of the subcontractors. The Contract further provided that "[n]either the Owner nor the Architect shall have any obligation to pay or to see to the payment of any moneys to any Subcontractors except as may otherwise be required by law." Contract article 9, section O.

B & H procured the necessary payment and performance bonds on May 31, 1991, from the surety, Capitol Indemnity Corporation ("CIC"), with whom it had a general indemnity agreement dating back to May 1989 (the "Agreement"). In the Agreement, B & H assigned all of its rights under future contracts to CIC; this assignment was subject to defeat if B & H did not default on its obligations.[1]

[1] The Agreement stated in pertinent part:

> [B & H does] hereby assign, transfer and convey to the Surety, all of their right, title, interest and estate in and to all

(Footnote continued on following page)

Section 11 of the Agreement also purported to create a trust in the contract funds, "for the benefit of and for payment of all obligations for labor and material furnished in connection with such contract * * * for which the Surety would be liable under said bond or bonds" (Gov. Br. App. 39).

Work on the project commenced on June 4, 1991, followed almost immediately by problems: B & H fell behind schedule, and subcontractors began complaining about delayed or inadequate payments. The subcontractors did not then or at any other time file notices of liens pursuant to § 23 of Illinois' Mechanics Lien Act, 770 ILCS 60/0.01 *et seq.*, which governs liens against public funds. The District modified the contract in an effort to ensure completion before school started but B & H was unable to make up lost time, and the August 9 deadline came and went with no end to the work in sight.

By early September, B & H had completed $143,993 of the work and had submitted its application for the second progress payment. Hovering over that sum (which, minus previously paid sums and agreed-upon retainage, totaled $102,341), however, was the long shadow of the Internal Revenue Service ("IRS"). In late July 1991, the IRS informed B & H of a federal tax obligation (unrelated to the District work) in the amount of $124,448.51. B & H failed to pay this sum and on September 12, 1991, the IRS served a notice of levy on the District for all property owned by B & H and in the District's possession. IRS officials instructed the District not to pay B & H any money owed it, but instead to send funds to the IRS.

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[1] *continued*

of their property, real, personal or mixed, wherever situated or of whatever nature, in which [they] have, or may hereafter obtain, an interest including but not limited to [rights under the construction contract], such assignment to be effective as of the date hereof, subject to being defeated in the event there is no [breach] of the obligations contained in or covered by [this bond].

The District's architect had forwarded B & H's application for the contested progress payment to his home office on September 9, 1991, with a recommendation that it be paid. After hearing about the IRS lien, however, District officials decided not to issue the funds to B & H. Although the District's architect formally certified the pay application on September 17, neither B & H nor the IRS was ever paid. On October 7 the District declared B & H in default, and on October 9 formally demanded that CIC perform on its bonds and complete the project.[2] CIC finished the job, paid the subcontractors, and received the withheld payment of $102,341 from the District in May 1992, along with the remainder of the Contract funds.

CIC subsequently filed suit against the government, challenging the levy as unlawful and claiming that B & H had no property interest in the $102,341 progress payment. CIC sought a declaration that its rights were superior to those of the United States, and an injunction against the United States from enforcing the levy. The government responded by counterclaiming that the progress payment was impressed with the lien, and also by filing a third-party counterclaim against the District for its failure to honor the levy.

The district court granted summary judgment against the government on both claims. The court held that the Illinois Mechanics Lien Act entitled the subcontractors to the portion of the progress payment that represented their work. Therefore, the court found that $85,921.70 was due the subcontractors and properly paid over to CIC on their behalf. As to the remaining $16,420, the district court held that the Agreement between CIC and B & H had transferred any remaining property right in the progress payment to the surety on the date that CIC issued the payment and performance bonds. The court concluded

[2] B & H's owners filed for relief under Chapter 7 of the Bankruptcy Code on October 11, 1991; the corporation itself filed for Chapter 7 relief on October 30, 1991.

that B & H had no property right in the progress payment, and that the government thus had nothing to levy against.

DISCUSSION

If B & H possessed the sole property interest in the progress payment at the time of the tax lien, the IRS was empowered to levy on those funds and would prevail in the absence of a prior lien. See *Avco Delta Corp. Canada Ltd. v. United States*, 484 F.2d 692 (7th Cir. 1973), certiorari denied, 415 U.S. 931; 26 U.S.C. § 6321. State law governs the initial inquiry of whether the progress payment constituted property of B & H; federal law determines whether the state-created property right is one which a tax lien can reach. *Aquilino v. United States*, 363 U.S. 509, 512-514. If the progress payment was B & H's property to which a tax lien could attach, the focus shifts to examining lien priorities, which requires the application of federal law. *Id.* at 514.

I. Property Rights

It is to these questions that we now turn, with the first step an examination of whether B & H or some other entity—namely the subcontractors, the District, or the surety—possessed a property interest in the progress payment at the time of the IRS lien.

A. The Subcontractors

We begin by analyzing the subcontractors' interest.[3] CIC contends that Contract language stating that "Con-

[3] Although the subcontractors press no claim in this action their rights are nonetheless important: if they originally had a valid claim to the progress payment, the IRS' attempted lien on the entire sum was unlawful. Moreover, CIC as surety succeeded to any rights the subcontractors had under the theory of equitable subrogation.

tractor shall pay each Subcontractor, upon receipt of payment from the Owner, an amount equal to the percentage of completion allowed to the Contractor on account of such Subcontractor's work" (Gov. Br. App. 74-75 ¶ J) created a trust for the benefit of the subcontractors in which B & H functioned as a "conduit" with only legal title to the funds. The above-quoted language manifests no intent to create a trust, however, but merely indicates that payment of the subcontractors was B & H's responsibility rather than the District's. The subcontractors' claim is further diminished by the fact that the Contract does not establish a discrete trust corpus. B & H was not required to pay the subcontractors out of specific funds or to turn over portions of the progress payment directly, but only to pay the subcontractors after the District paid B & H. See *LaThrop v. Bell Federal Sav. and Loan Ass'n*, 68 Ill. 2d 375, 370 N.E.2d 188 (1977) (lacking an "express provision in the contract indicating" that segregation of funds was contemplated, the court found no trust had been created), certiorari denied, 436 U.S. 925; see also *In re Construction Alternatives*, 2 F.3d 670, 676-677 (6th Cir. 1993) (segregation of funds critical to finding existence of trust). Section 11 of the Agreement, purporting to create a trust for the subcontractors and the surety in the Contract proceeds, is mere boilerplate, which Illinois courts generally view with suspicion. See, *e.g.*, *G.H. Miller & Co. v. Hanes*, 566 F. Supp. 305, 308 (N.D. Ill. 1983). While the "boilerplate" characterization is not dispositive, as we will see, section 11 conflicts with limitations on rights implicit in the Illinois Mechanics Lien Act. This fact also militates against imbuing the "trust" provision with much significance. See *In re Wm. Cargile Contractor, Inc.*, 151 B.R. 854, 859-860 (Bankr. S.D. Ohio 1993) (finding trust would be "contrary to requirements under the state mechanic's lien statutes, since subcontractors would not need to concern themselves with filing proper liens so long as the surety had executed a trust agreement similar to the ones herein"); see also *Construction Alternatives*, 2 F.3d at 676-677 (indemnity provision nearly identical to section 11 did not create express trust).

The Contract itself spells out the subcontractors' rights—more precisely, their lack of rights—in the progress payment. The relevant provision in the Contract, at article 9 section O, states that "[n]either the Owner nor the Architect shall have any obligation to pay or to see to the payment of any moneys to any Subcontractors except as may otherwise be required by law" (Gov. Br. 22). The first part of this directive dispenses with CIC's argument that the Contract explicitly contemplates giving rights in the progress payment to the subcontractors.

Thus CIC must rely on section O's final clause, which brings into play any state law that might offer the subcontractors additional recourse. See *DC Electronics, Inc. v. Employers Modern Life Co.*, 90 Ill. App.3d 342, 348, 413 N.E.2d 23 (1st Dist. 1980) (under Illinois law, "statutory provisions applicable to a contract * * * are deemed to form a part of the contract and must be construed in connection therewith"), *cited in Western Waterproofing Co., Inc. v. Springfield Housing Authority*, 669 F. Supp. 901, 903 (C.D. Ill. 1987). Relevant here is the section of the Illinois Mechanics Lien Act, 770 ILCS 60/23, regarding publicly funded works.[4]

The Act endows "[a]ny person who shall furnish material, apparatus, fixtures, machinery or labor to any contractor having a contract for public improvement for any * * * school district * * * in this State" with "a lien for the value thereof." 770 ILCS 60/23; see also *Chicago Bridge & Iron Co. v. Reliance Ins. Co.*, 105 Ill. App. 2d 91, 99, 245 N.E.2d 127 (1st Dist. 1969), reversed on other grounds, 46 Ill. 2d 522 (1970). However, § 23 requires the would-be lienor to provide written notice to school officials

[4] The district court relied exclusively on a 1953 Illinois appellate case, *Robertson v. Huntley & Blazier Co.*, 351 Ill. App. 378, 115 N.E.2d 533 (4th Dist. 1953), for its conclusion that the subcontractors had property rights in the progress payment under Illinois law. That case involved private contracts and invoked a different section of the Mechanics Lien Act. *Robertson*, therefore, is inapposite to the resolution of this case.

and the general contractor in order to perfect the lien. 770 ILCS 60/23; *Wilbur Waggoner Equipment Rental & Excavating Co. v. Johnson*, 33 Ill. App. 3d 358, 362, 342 N.E.2d 266 (5th Dist. 1975). None of the subcontractors in the instant action complied with this procedural prerequisite; hence they forfeited their inchoate statutory lien. See *Board of Education of School Dist. No. 108 v. Collom*, 77 Ill. App. 2d 479, 222 N.E.2d 804 (3rd Dist. 1966) (failure to perfect lien according to § 23 places subcontractor in same position as other general creditors). For subcontractors performing work for public bodies, such as the District, adherence to the procedural dictates of § 23 is a necessary prerequisite to the attainment of rights in a progress payment.

CIC makes additional arguments concerning the subcontractors' alleged property rights in the progress payment, claiming that the subcontractors accrued rights under an equitable lien theory, as third-party beneficiaries or under an implied trust. All of these arguments are unavailing. Illinois case law recognizes subcontractors' equitable rights in construction contracts under the above theories in the context of disputes over retainage fees, which the *Avco Delta* court described as a sort of "liquidated damages clause." 484 F.2d at 701. Funds intended from the inception of a contract to settle potential claims differ vastly from progress payments, which belong to the free flow of commerce from the time they are properly paid over. See *Northwest Water Comm'n v. Carlo V. Santucci, Inc.*, 162 Ill. App. 3d 877, 895, 516 N.E.2d 287 (1st Dist. 1987) (distinguishing between retainage and amounts already paid over), appeal denied, 119 Ill. 2d 559, 522 N.E.2d 1247 (1988); see also *International Fidelity Ins. Co. v. United States*, 949 F.2d 1042, 1046 (8th Cir. 1991). We are therefore unpersuaded by the rationales advanced in the case law presented by CIC. By failing to adhere to the Mechanics Lien Act, the subcontractors in this case lost their priority interest in the progress payment, and cannot be said to have any property right in that sum.

B. The Surety

But what about CIC? As the surety, CIC ostensibly succeeded to all of B & H's rights under the Contract through the Agreement, which assigned these rights when the payment and performance bonds were issued. If this assignment were effective as written, then at the time of the IRS lien the progress payment would have belonged to CIC, not B & H.

The "assignment," however, simply granted CIC an unperfected security interest in the Contract proceeds until the time B & H actually defaulted and CIC had to perform on the bonds. See *United States v. R.F. Ball Construction Co.*, 355 U.S. 587 (similar assignment created "inchoate and unperfected" security interest). In this case, the Agreement itself was ambiguous in its attempt to create an effective assignment of rights: as noted above, the boilerplate language in section 11 purported to create a trust in future contract earnings for the benefit of the surety and the subcontractors. Had the "assignment" in the Agreement been effective before default, the "trust" provision would have made no sense. Section 11's attempted trust is inconsistent with and thus renders additionally implausible B & H's ostensible assignment of all of its rights under the Contract to CIC, dating back to the time the bonds were issued. Prior to default, then, B & H and not CIC had rights in all monies already paid over. See *Fidelity & Deposit Co. of Md. v. Scott Bros. Const. Co.*, 461 F.2d 640, 643 (5th Cir. 1972) ("Any payments made by the owner prior to default * * * are attributable to the contractor's performance, not the surety's.").

For purposes of analyzing CIC's direct interest, the question becomes one of timing: did B & H default before or after the IRS invoked its tax lien?[5] Although the dis-

[5] This question also affects any rights claimed by the District. Upon a valid declaration of default, the District could legitimately have withheld unpaid Contract funds in order to finish the project.

(Footnote continued on following page)

trict court reserved judgment on this issue, the record seems clear as a matter of law that only on October 7, 1991, did the District terminate B & H's ability to perform on the Contract, and only on October 9 was CIC required to perform any of the duties inherent in its role as surety. While CIC now contends that B & H's concededly inadequate performance from day one constituted default, both the surety and the District appear to have anticipated that B & H would complete the project (albeit behind schedule) up until the day the IRS notified school officials of the pending lien. Indeed, the District made substantial efforts through September to ensure that B & H stayed on the project, frequently modifying the Contract through written change orders that reduced or altered work specifications and amounts owed to B & H. The District's actions served to waive their early opportunities to declare B & H in default under the Contract, and by extension to postpone CIC's accrual of rights.

As for the surety, CIC could not, upon hearing of B & H's performance problems or liquidity concerns, have forced the District to declare a default. See *United States v. Continental Cas. Co.*, 346 F. Supp. 1239 (N.D. Ill. 1972) (federal government could waive technical default of contractor despite warnings from surety; fact that surety's subrogation rights were impaired was less important than government's interest in completing the job efficiently). As *Continental Casualty* makes clear, the District was entitled to exercise discretion in deciding when to terminate B & H's performance; the fact that in doing so it curtailed CIC's rights is immaterial.

---

[5] *continued*

See *Gunther v. O'Brien Bros. Const. Co.*, 369 Ill. 362, 364, 16 N.E.2d 890 (1938) (upon a contractor's default prior to the completion of the work, a public body may use withheld funds to complete the job), *cited in Santucci*, 162 Ill. App. 3d at 894-895. By waiving its right to declare default until after it had certified the progress payment, however, the District forfeited its claim in the funds.

The conclusion that B & H did not default until after the IRS issued its lien disposes of CIC's direct rights as assignee as well as its right of equitable subrogation in other valid claims. As completing surety, CIC was subrogated to the rights of several parties: the original contractor, the subcontractors and suppliers, and the owner (here the District) for whom the job was completed. See *National Shawmut Bank of Boston v. New Amsterdam Cas. Co.*, 411 F.2d 843, 845 (1st Cir. 1969) (surety assumes rights of numerous parties on contractor's default). The right of subrogation, which entitled CIC to "step into the shoes" of any party whose obligations it assumed, would not take effect until CIC actually assumed these obligations. See *American Cas. Co. of Reading, Pa. v. Line Materials Industries*, 332 F.2d 393 (10th Cir. 1964) (noting "clear distinction" between right of subrogation, which exists from date bond is executed, and actual subrogation, which occurs only when payments are made on contractor's default), certiorari denied, 379 U.S. 960.

By the time CIC could assert its right of subrogation, no claims remained for the surety to be subrogated to: the subcontractors had lost their potential interest by failing to file notices of lien, B & H had had its property subjected to the IRS lien, and the District had neglected to take the opportunity to declare B & H in default and to withhold the progress payment on that basis. CIC's claim of subrogation rights, like its claim to a direct interest in the progress payment, thus fails.

II. Competing Lien Priorities

Having rejected CIC's contention that B & H did not have a property interest in the progress payment attachable by a federal lien, we must now determine whether CIC has a superior claim as completing surety. This answer is somewhat more straightforward: they do not. With respect to lien priorities, the well-known rubric that "first in time is the first in right" applies in this case. *United States by and through I.R.S. v. McDermott*, 113

S. Ct. 1526, 1528, *quoting United States v. City of New Britain*, 347 U.S. 81, 87. CIC could not prime its state-created surety's lien until B & H defaulted and when there was "nothing more to be done * * *—when the identity of the lienor, the property subject to the lien, and the amount of the lien [were] established." *City of New Britain*, 347 U.S. at 84. In this case, CIC did not step in and begin performing work and making payments on the project—prerequisites to priming its surety's lien—until October 9, 1991, well after the tax lien was in place.

CIC was also not entitled to prevail under the "super-priority" exception set forth in the Internal Revenue Code to give priority to certain inchoate claims. 26 U.S.C. § 6323(c). That statute provides in pertinent part that:

> (1) * * * To the extent provided in this section, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—
>
> (A) is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting—
>
> * * * (iii) an obligatory disbursement agreement, and
>
> (B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

Id. Although CIC's inchoate lien met the statutory definition of an "obligatory disbursement agreement," the surety's claim was not perfected, and thus not protected under local law against a judgment lien. See 810 ILCS 5/9-302 (Illinois law requires sureties to file financing statement in appropriate office in order to perfect claim). Accordingly, with no protection against a judgment creditor, CIC has none against the federal tax lien under the super-priority structure. See *Construction Alternatives*, 2 F.3d at 678.

CONCLUSION

In attempting to persuade this Court that the court below decided correctly, CIC reserves its most impassioned rhetoric for arguments regarding the rights of subcontractors to the fruits of their labor. Yet the subcontractors had available the shelter of the Illinois Mechanics Lien Act (which they forfeited) and the protection of the payment bond supplied by CIC (which resulted in their full payment). The party with a quantifiable monetary stake in this action was CIC, which is in the business of taking risks and appears to have bet on the wrong horse. Finding that CIC's claims are without merit and that B & H did in fact possess a property right in the progress payment which the IRS properly attached, we reverse the judgment of the district court and remand for further proceedings consistent with this ruling.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

USCA AO7XXXC-92-001—Midwest Law Printing Co., Inc., Chicago—11-30-94

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

January 23, 1995

Before

Hon. WALTER J. CUMMINGS, *Circuit Judge*

Hon. JOHN L. COFFEY, *Circuit Judge*

Hon. JOHN M. FERGUSON, *District Judge*

CAPITOL INDEMNITY CORPORATION, Plaintiff-Appellee, No. 93-3633 v. UNITED STATES OF AMERICA, Defendant-Third/Party Plaintiff-Appellant, v. MT. VERNON TOWNSHIP HIGH SCHOOL DISTRICT 201, Third/Party Defendant-Appellee.	Appeal from the United States District Court for the Southern District of Illinois, Benton Division. No. 92 C 4141 J. Phil Gilbert, Chief Judge.

The following are before the court:

1. MOTION FOR LEAVE TO FILE AMICUS BRIEF filed 1/13/95, by counsel for the Builder's Association of Greater Chicago.

2. MOTION FOR EXTENSION OF TIME filed 1/13/95, by counsel for the American Subcontractors Association and the American Subcontractors Association-Midwest Counsel.

3. MOTION FOR LEAVE TO FILE AMICUS BRIEF INSTANTER filed 1/19/95, by counsel for the Surety Association of America.

IT IS ORDERED that the motions are **DENIED**. No judge in regular active service has voted to rehear this case en banc. The Merits Panel has voted to deny the Petition for Rehearing. Accordingly, The Petition for Rehearing is **DENIED**.

Addendum

Internal Revenue Code of 1986 (26 U.S.C.):

SEC. 6323 VALIDITY AND PRIORITY AGAINST CERTAIN PERSONS

* * * * * *

(c) [as added by Sec. 101(a), Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 80 Stat. 1125.] Protection for Certain Commercial Transactions Financing Agreements, etc.-

(1) In general.--To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which--

(A) is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting--

(i) a commercial transactions financing agreement,

(ii) a real property construction or improvement financing agreement, or

(iii) an obligatory disbursement agreement, and,

(B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

* * * * * *

(4) Obligatory disbursement agreement.--For purposes of this subsection--

(A) Definition.--The term "obligatory disbursement agreement" means an agreement (entered into by a person in the course of his trade or business) to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.

(B) Limitation on qualified property.--The terms "qualified property," when used with respect to an obligatory disbursement agreement, means property subject to the lien

imposedby section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

(C) Special rules for surety agreements.--Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person--

(i) The term "qualified Property" shall be treated as also including the proceeds of the contract the performance of which was ensured, and

(ii) if the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term "qualified property" shall be treated as also including any tangible personal property used by the taxpayer in the

performance of such
ensured contract.

5/9-102. Policy and subject matter of article.

(2) This Article applies to security interest created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease for consignment intended as security. This Article does not apply to statutory liens except as provided in Section 9-310.

5/9-302. When filing is required to perfect security interest--Security interest to which filing provisions of this article do not apply

§ 9-302. When Filing is Required to Perfect Security Interest; Security Interests to Which Filing Provisions of This Article Do Not Apply. (1) A financing statement must be filed to perfect all security interest except the following:

(a) a security interest in collateral in possession of the secured party under Section 9-305;

FILED
MAY 25 1995

No. 94-1768

In the Supreme Court of the United States

OCTOBER TERM, 1994

CAPITOL INDEMNITY CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether, on the facts of this case, petitioner's interest as a surety in an earned progress payment was entitled to the superpriority protection afforded by 26 U.S.C. 6323(c).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-13a) is reported at 41 F.3d 320. The opinion of the district court is reported at 93-2 U.S. Tax Cas. (CCH) ¶ 50,603.

JURISDICTION

The judgment of the court of appeals was entered on November 30, 1994. The petition for rehearing was denied on January 23, 1995 (Pet. App. 14a). The petition for a writ of certiorari was filed on April 24, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In May 1991, B & H Construction Company contracted with Mt. Vernon Township High School District No. 201 for asbestos removal and other work to be completed by August 9, 1991, for a total price of $248,340. The contract price was due in monthly progress payments upon certification by the project architect that the appropriate share of the work had been completed satisfactorily and that the subcontractors and suppliers had been paid. The contract provided for a ten percent "retainage" to be withheld from each progress payment until the satisfactory completion of the project. The contract further provided that neither the school district nor the architect had any contractual obligation to pay subcontractors for any work they might perform at the contractor's direction (Pet. App. 2a).

As required by the contract, the contractor procured payment and performance bonds on May 31, 1991. The bonds were issued by petitioner as surety. The contractor also had a preexisting general indemnity agreement with petitioner under which the contractor assigned to petitioner all of its rights under its construction contracts. That assignment was subject to defeasance upon the satisfactory completion of the contract work (Pet. App. 2a).

Work on the project began on June 4, 1991, but the contractor immediately fell behind schedule. Even after the school district modified the contract to reduce the work to be done, the contractor still failed to meet the modified deadlines. The August 9, 1991, completion date arrived with no end to the job in sight. The subcontractors began complaining about delayed or inadequate payments but did not file a

notice of lien pursuant to Section 23 of the Illinois Mechanics Lien Act, 770 Ill. Comp. Stat. 60/0.01 (1993) *et seq.* (Pet. App. 3a).

By early September 1991, the contractor had completed work under the contract valued at $143,993. The contractor submitted a progress payment application which, minus previously paid sums and retainage, totaled $102,341. That application was formally certified for payment on September 17, 1991 (Pet. App. 4a).

Meanwhile, in July 1991, the Internal Revenue Service had notified the contractor of an unpaid federal tax assessment in the amount of $124,448 and filed notices of lien with respect to that assessment. When the contractor failed to pay the assessment, the Service issued a notice of levy to the school district on September 12, 1991 (Pet. App. 3a). Upon receipt of the notice, the school district decided not to issue the progress payment to either the contractor or the Internal Revenue Service. Instead, on October 7, 1991, the school district declared the contractor in default and, on October 9, 1991, demanded that petitioner perform on its bonds and complete the project. Petitioner completed the project and paid the subcontractors. In May 1992, petitioner received the withheld progress payment of $102,341 from the school district, along with the remainder of the contract funds (*id.* at 4a).

2. Petitioner brought this action alleging that the tax levy was wrongful because the contractor had no interest in the progress payment. The government counterclaimed that the progress payment was impressed with its lien and also filed a third-party counterclaim against the school district for failure to honor the levy (Pet. App. 4a).

On a motion for summary judgment, the district court held against the government on both claims. The court held that the Illinois Mechanics' Lien Act entitled the subcontractors to the portion of the progress payment that represented the work that they had completed ($85,921) and that this amount was correctly paid to petitioner on the subcontractors' behalf. The court further held that the balance of the payment ($16,420) belonged to petitioner, rather than the contractor, because the general indemnity agreement effected an assignment of the contractor's rights to petitioner (Pet. App. 4a). The court concluded that the contractor "had no property right in the progress payment, and that the government thus had nothing to levy against" (*id.* at 5a).

3. The court of appeals reversed (Pet. App. 1a-13a). The court rejected the district court's conclusion that the contractor had no property interest in the progress payment to which the federal tax lien could attach.

The court held first that the progress payment was not the property of the subcontractors (to which petitioner, as surety, would have succeeded under the theory of equitable subrogation) but was instead the property of the general contractor. The court reached that conclusion because (i) the contract between the school district and the contractor did not give the subcontractors any rights in the progress payment or create a trust for their benefit, (ii) the subcontractors had failed to comply with the applicable state law providing them recourse outside the contract (Illinois Mechanics Lien Act, 770 Ill. Comp. Stat. 60/23) (1993) and (iii) Illinois law recognized a subcontractors' equitable rights in con-

struction contracts only for retainages and not for progress payments (Pet. App. 5a-8a).

Relying on *United States* v. *R.F. Ball Construction Co.*, 355 U.S. 587 (1958), the court of appeals further rejected the district court's determination that the general indemnity agreement transferred all rights in the progress payment from the contractor to petitioner. The court held that the assignment created by that agreement gave petitioner only an unperfected security interest in the contract proceeds until the contractor defaulted and petitioner was called upon to perform on its bonds. The court noted that default did not occur until the school board declared it *after* the notice of federal tax lien for the contractor's unpaid taxes had been filed (Pet. App. 9a-11a).

The court of appeals concluded that petitioner's right of equitable subrogation—which entitled petitioner to "step into the shoes" of the contractor and subcontractors—did not take effect until petitioner undertook substitute performance under the surety bonds. The court stated (Pet. App. 11a):

> By the time [petitioner] could assert its right of subrogation, no claims remained for the surety to be subrogated to: the subcontractors had lost their potential interest by failing to file notices of lien, B & H had had its property subjected to the IRS lien, and the [school] [d]istrict had neglected to take the opportunity to declare B & H in default and to withhold the progress payment on that basis.

Having determined that the contractor had a property interest in the progress payment to which the federal tax lien attached, the court of appeals con-

cluded that the federal tax lien primed petitioner's unperfected security interest in the contract rights. Because the surety's lien was not perfected until after the notice of federal tax lien had been filed, the federal lien prevailed under the principle that the "first in time is first in right" (Pet. App. 11a).

The court then rejected the further claim that petitioner was entitled to prevail under the "superpriority" exception of 26 U.S.C. 6323(c). The court noted that, for the "superpriority" provision to apply, petitioner's surety's lien had to be protected under local law, as of the time of tax lien filing, against a judgment lien arising out of an unsecured obligation (Pet. App. 12a, citing 26 U.S.C. 6323(c)). Petitioner's surety claim did not qualify under this provision because petitioner had failed to file a financing statement with the appropriate state office and was therefore not protected against other unsecured creditors under the applicable local law (Pet. App. 11a-12a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court, any other federal appellate court or the highest court of Illinois. Further review of the question of Illinois law presented by the petition is not warranted.

1. The court of appeals correctly concluded that, under Illinois law, the surety did not have a valid claim of subrogation in the funds that were subject to the federal lien.

a. Petitioner had no right of subrogation through the subcontractors because the subcontractors themselves had no contract right to any share of the progress payment (Pet. App. 7a). The court of appeals correctly determined that Illinois law recognizes a

subcontractor's equitable rights in a construction contract only for retainage payments, not for progress payments. See *Avco Delta Corp. Canada Ltd.* v. *United States*, 484 F.2d 692 (7th Cir. 1973), cert. denied, 415 U.S. 931 (1974). In addition, the subcontractors had not complied with the Illinois Mechanics Lien Act and therefore had no statutory lien claim directly against the progress payment (Pet. App. 8a). See *Board of Education of School Dist. No. 108* v. *Collom*, 222 N.E.2d 804 (Ill. App. Ct. 1966).

b. The court of appeals also correctly found that petitioner had no right of subrogation through the school district. The school district did not declare a default until after it certified the progress payment; it thereby forfeited its claim to the fund under Illinois law. See *Northwest Water Commission* v. *Carlo* V. *Santucci, Inc.*, 516 N.E.2d 287 (Ill. App. Ct. 1987), appeal denied, 522 N.E.2d 1247 (Ill. 1988).

c. The court of appeals also correctly found that the surety had no right of subrogation through the contractor itself. The contractor's interest in the progress payment was unquestionably subject to the federal tax lien under 26 U.S.C. 6321 (Pet. App. 11a).

2. The court of appeals then turned to the separate question whether 26 U.S.C. 6323(c) affords petitioner's claim as surety a "superpriority" against the federal tax lien. That statute permits certain types of lien claims to prevail against an earlier-filed tax lien if the later lien would be protected, under state law, against "a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation." 26 U.S.C. 6323(c)(1)(B). The court of appeals correctly determined that the surety's claim in this case—based upon the ostensible assignment provision of the general indemnity agreement—was *not* protected

against a judgment lien under state law. As the court noted, the surety had failed to perfect its claim against unsecured creditors by filing a financing statement in accordance with Illinois law (Pet. App. 12a, citing 810 Ill. Comp. Stat. 5/9-302 (1993)).

Petitioner cites several cases for the proposition that a surety is not required to file a financing statement to perfect its security interest in contract proceeds (Pet. 2-3, 12-14). All but one of those cases, however, involve the law of different States; they therefore do not evidence a conflict on the question of Illinois law decided by the court of appeals in this case.

The one case cited by petitioner that applies Illinois law (*Home Indemnity Co.* v. *United States*, 433 F.2d 764 (Ct. Cl. 1970)) does not conflict with the decision in this case. The *Home Indemnity* case concerned the right of a surety to funds withheld from a contractor pending completion of the project. The court held that the surety had a claim of equitable subrogation to the funds due on completion of the contract (*id.* at 765). Because the common law right of subrogation is not a "security interest" to which the requirements of the Uniform Commercial Code apply, however, the *Home Indemnity* court did not address or decide the question decided in this case. See *ibid.* There is thus no conflict among the circuits on the question of Illinois law decided by the court of appeals in this case. See also *Ruhlin* v. *New York Life Ins. Co.*, 304 U.S. 202, 206 (1938).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1995